

The multiple obstacles facing economic stimulus

The Q2 GDP data and June econ numbers show that the stimulus measures rolled out in recent months are providing little succor to the economy in the face of weak consumer spending and a collapsing real estate sector.

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Key takeaways

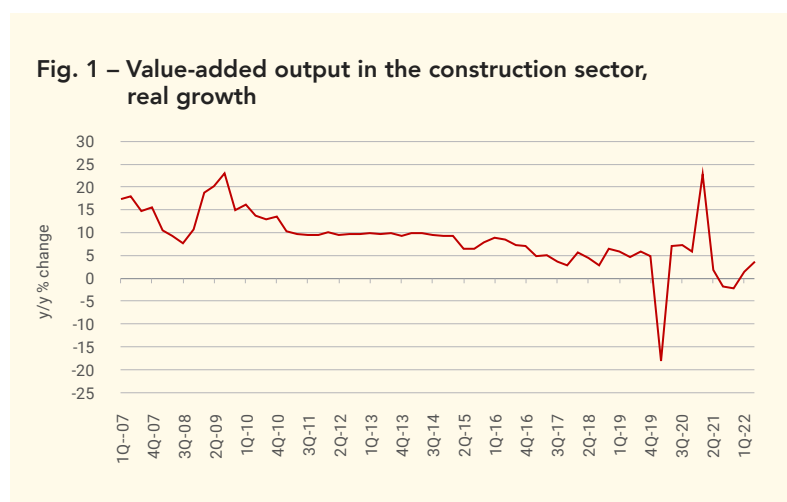
- Infrastructure investment ramped up in the second quarter, and Q2 GDP data showed increased value-added output growth in the construction sector.
- However, the econ data also showed how this stimulus' economic impact was quashed by plummeting real estate construction.
- Going forward, this means that spending needs to increase on a scale large enough to overcome the economic drag from real estate before lifting economic growth.
- Infrastructure stimulus, in particular, will also need to be large enough to overcome the fact that its initial impact will be to allow producers to draw down high inventories rather than generate new industrial production.
- However, while substantial infrastructure funding is coming down the line, there are several obstacles to generating enough economic activity to significantly impact headline growth rates. The most obvious concern is that more COVID-related disruptions hold back construction work – rendering the scale of stimulus funds that are in place academic. The other worry is whether there are enough shovel-ready projects to absorb this stimulus money.
- Without a construction-led boost to economic activity, it is difficult to see what else could drive a serious pick-up in growth rates. Exports could bolster industrial production if stimulus fails to deliver, but given the worsening outlook for global demand, this will need to be accompanied by price cuts.
- Consumer spending remains weak as households continue to struggle with low income growth. The pipeline of stimulus in this area is also far more meager than for infrastructure.
- Our concern, therefore, is that even as infrastructure funding gets ramped up further in H2, its transmission to economic activity will be undermined by these obstacles, resulting in a disappointing recovery.

While China just about managed to eke out a 0.4% y/y increase in GDP in Q2, the econ numbers for that quarter highlight the urgent need for more stimulus. Of particular concern is that the Q2 numbers show that stimulus efforts were, in fact, already being ramped up that quarter. The problem was that these efforts didn't yield much in the face of still weak consumer spending and a collapsing real estate sector.

Infrastructure fixed-asset investment (FAI) increased 8.6% y/y in Q2, with spending growth ending the period at 12.0% y/y – the biggest y/y increase since March 2021.

There was also a notable increase in spending by state-owned entities compared with their private sector peers. The former rose 8.0% y/y in 2Q22; the latter just 0.6%.

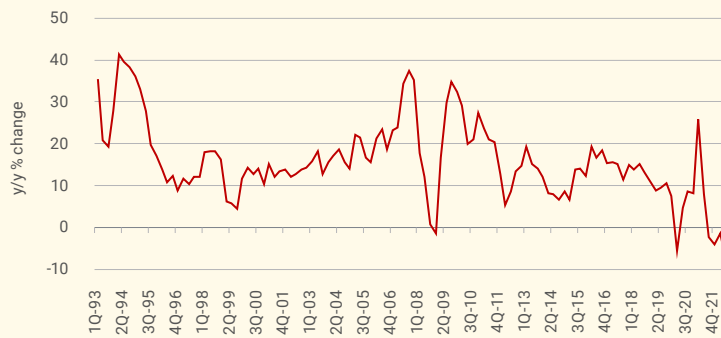
This stimulus translated into an acceleration in growth in value-added output in the construction sector – which mainly reflects infrastructure projects – in the three months to June. Output increased 3.6% y/y in real terms, up from 1.4% in 1Q22 [FIG 1].



However, the economic impact of this increase in infrastructure spending was quashed on a couple of different fronts.

First, this infrastructure investment has focused on water conservation and utilities, which increased 12.0% and 13.1% y/y, respectively, in 2Q22. However, investment in more commodities-intensive transportation projects – which tend to have a bigger second-order economic impact – only rose 2.1% y/y.

Plummeting real estate construction is also diminishing the economic impact of higher infrastructure investment. Value-added output in the real estate sector collapsed 7.0% y/y in 2Q22. In nominal terms, output growth fell to a record low of minus 6.9% y/y last quarter – even worse than in 1Q20 [FIG 2].

Fig. 2 – Value-added output in the real estate sector, nominal growth

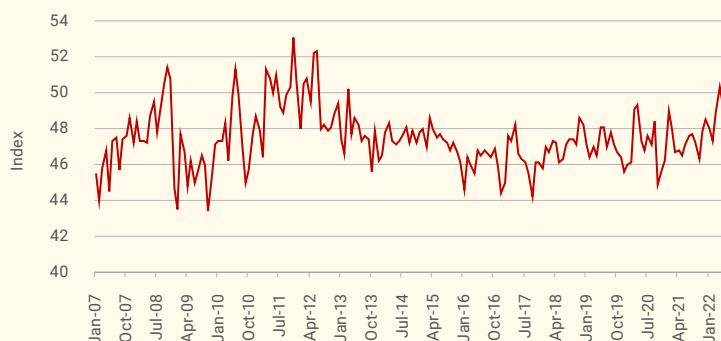
Stimulus obstacles

Looking at stimulus efforts in the rear-view mirror highlights some of the problems facing Chinese officials. Infrastructure spending in Q2 was channeled into projects that produce less of a second-order boost to economic activity than traditional infrastructure stimulus, and the increase in investment took place alongside a record collapse in real estate activity.

Both factors mean that infrastructure investment must occur on a far larger scale to significantly impact overall growth.

A more forward-looking take on things is not that much more positive. The concern here is the evidence that sectors upstream to infrastructure have jumped the gun and ramped up production in anticipation of a level of demand that has still not materialized.

Finished goods inventories at steel mills, for example, are currently 28% larger than at the same time last year. The NBS Manufacturing PMI finished goods inventories subindex also remains at a historically high level, suggesting elevated stock levels [FIG 3].

Fig. 3 – NBS Manufacturing PMI: Finished Goods Inventories

This means that a portion of any increase in infrastructure investment will be met from inventories rather than new industrial production. In other words, just to achieve the same stimulus impact as seen in Q2,

infrastructure spending actually needs to be considerably more in the coming months to overcome the draw-down from high inventories.

The good news is that there does indeed appear to be more stimulus coming down the line.

In the coming two to three months, officials are set to unleash a major infrastructure stimulus. This will likely end up in the range of RMB 2.85-3.05 trillion – up to 2.7% of GDP (see [China's coming Q3 infrastructure investment surge](#)). The number might wind up even higher, with rumors that local governments will be allowed to start issuing and spending their 2023 special-purpose bond quota in the second half of this year.

There are also some grounds for thinking that real estate construction may start to pick up in the coming months. The wave of mortgage boycotts by households waiting for the properties they have purchased to be completed will ramp up pressure on developers to finish building housing units sold off-plan. This might provide a short-term boost to real estate construction.

What can go wrong?

That is the bullish case for construction-led growth in the coming months, but a lot can go wrong.

Most obviously, if the current increase in COVID-19 cases prompts more lockdowns, this will hold back construction activity – whatever the scale of stimulus funds.

The other worry is whether there is a sufficient number of shovel-ready projects to absorb this stimulus money. This has been a perennial problem in boosting infrastructure spending. The risk is that given the other claims on local governments – from the need to increase fiscal outlays to fight COVID-19 outbreaks and the struggle many have just to pay everyday expenses – some of this stimulus financing gets diverted into these other areas instead of going into growth-boosting infrastructure investment.

What we will be looking for, therefore, is an increase in activity in sectors like steel that would suggest that this expansion in infrastructure funding is being utilized in growth-boosting areas – and that this is boosting infrastructure construction in a large enough way to counter the fall in real estate activity.

However, the signs so far are not good. Steel production in the first 10 days of July was down 9% from the same period in June. While some of this probably reflects producers cutting output to work through inventories, it also suggests that a summer bounce in construction activity is still not forthcoming.

Limited alternatives

Without a construction-led boost to economic activity, it is difficult to see what else could drive a serious pick-up in growth rates.

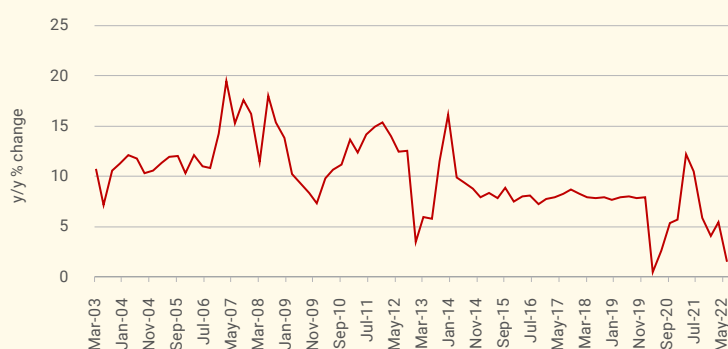
Exports offer a potential way to absorb industrial oversupply and sustain production in the absence of construction demand. But given the dire

outlook for global economic growth, prices would have to be cut to boost orders.

The outlook for domestic spending is not much better, and the stimulus pipeline here is far more barren than for the infrastructure sector. Officials have cut the purchase tax on some passenger vehicles by half, and some local governments are supplementing this with subsidies for NEV purchases. However, despite the 13.9% y/y jump in car sales in June because of this stimulus, broader retail sales remain extremely weak, increasing only 3.1% y/y last month. With the retail price index rising 3.7% y/y in June, spending fell in real terms.

The weak June retail sales data shows that it's not just lockdowns that have constrained a recovery in consumer spending but also households still reluctant to open their wallets. It is not hard to see why. The quarterly household income data from the NBS showed that per capita disposable income in urban areas increased just 1.5% y/y in Q2 [FIG 4]. And while the official urban unemployment rate came down last month – falling to 5.5% from 5.9% in May and a high of 6.1% in April – it remains higher than the 5.1% average recorded last year. Moreover, joblessness for graduates continued to rise last month, increasing to 19.3% – the most since at least January 2018 – when records began.

Fig. 4 – Per capita urban disposable income



Our concern, therefore, is that even as stimulus funding gets ramped up further in Q2, its transmission to economic activity will be obstructed by ongoing COVID-related disruptions, the difficulty of finding enough projects to absorb all these funds, and the fact that part of this stimulus will go into drawing down high industrial inventories.

That leaves us concerned that the stimulus will not be of large enough scale to generate the hefty boost to growth that is needed, given the drags on economic activity from the real estate sector, consumer spending, and the likely drop in overseas demand.